Richmond House Investment Management- Investment Commentary – Q3 2017

Although the Federal Reserve raised interest rates for the second time this year at the end of June, the US dollar continued to weaken over the quarter and financial conditions became even easier. This supported risk assets and all asset classes generated positive returns with the exception of government debt. These conditions were most beneficial for emerging markets, which are sensitive to the strength of the US dollar, while investors were also relieved by the Chinese leadership's move to rein in leverage in the economy. Positive returns were generated from the RHIM (Richmond House Investment Management) models over the quarter, ranging from 0.4% (RHIM Strategic) to 1.8% (RHIM Enterprise) to 30th September 2017.

In the USA, President Trump continued to fight for the repeal of Obamacare and for tax reform with limited success. By siding with the Democrats in the Senate, he was able to postpone negotiations on the $20 trillion debt ceiling from September to December while the country was devastated by hurricanes and forest fires. Negotiations with Russia and China over North Korea's nuclear missile tests and ISIS in Syria have called America's influence into question and the threat of sanctions on Venezuela, Iran and Russia has had little impact on the oil price. The weaker US dollar has increased the value of overseas earnings in local currency terms and US stockmarkets continued to rise over the quarter. Indeed, they have risen with unparalleled consistency and records have been broken for the lack of volatility in the market. Towards the end of the quarter the Federal Reserve announced that it would start to unwind its balance sheet which should tighten monetary conditions. We remain underweight US equities and we reduced our US dollar exposure a bit more in the quarter. With China slowing the rate of growth in its credit markets and Europe and Japan tapering their bond purchases, we shall have to watch what impact this has on the leveraged global economy.

In the UK, the Bank of England also talked of withdrawing its monetary stimulus and of raising interest rates in November for the first time since July 2007. This caused the pound to jump 3% against the dollar and the euro and it helped to offset the weakness from the troubled Brexit negotiations. This had a negative impact on the valuation of assets held in overseas currencies. Wage growth in the UK continues to be weak and below inflation while London house prices have started to fall. We continue to be cautious about sterling and its impact on portfolio. In Europe, the current economic resurgence has pushed the political problems into the background for the time-being but the rise of the far-right Alternative fur Deutschland (AFD) to third in the German elections and the Catalan referendum at the end of the quarter remind us that they have not been solved. European stocks have done well for the portfolios in the first half of 2017, more so due to currency moves than the underlying equity performance.

In emerging markets, China has continued to transition away from the basic industry export model to a more domestic services economy with a particular focus on improving the environmental and living conditions of its population. Inefficient manufacturing companies have been shut down for the greater benefit of the rest of the industry and the banking sector and economic growth is being talked of in terms of quality rather than quantity. In terms of the stockmarket in China, performance this year has been strong after several years of lacklustre performance. However, such is the size of companies such as Tencent and Alibaba that one third of the Chinese stock market (MSCI China) is now made up of three internet stocks.

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In India, President Modi has shocked the economy for a second time in a year with the imposition of a Goods & Services Tax (GST) to replace the previous complex of indirect taxes. The new regime caught many ill-prepared and its implementation is causing considerable problems for business owners.

Stockmarkets, globally, were up in the quarter, with emerging markets outperforming (the IA Global Emerging Market sector was up 4.4% in sterling terms). Commodity and technology sectors were the best-performing sectors and defensive sectors, like healthcare, telecommunications and utilities, were the weakest. Equities continue to look fully-valued on historic metrics except in comparison with fixed income where credit spreads fell to such an extent that European high-yield bonds, ie junk bonds of the lowest credit quality, now yield less than the established safe haven of 10-year US government debt. While UK gilts generated a small loss over the quarter, credit funds just made a positive return. We remain underweight interest rate risk as central banks talk of raising rates and underweight credit risk due to expensive valuations.

The WTI crude oil price rose from $46 to $51 on the back of disruption to US facilities in the Gulf of Mexico when hurricane Harvey hit but US oil production and oil exports rose to record levels in the quarter. In addition, Saudi Arabia declared war on Qatar after it requested the internationalisation of the holy sites, raising tensions in the Persian gulf. Under pressure from the USA, Venezuela and Iran have announced that they won't sell oil in US dollars. Commodities, broadly, rose over quarter, after China closed its inefficient producers.

The performance of the RHIM models over this period and the six months has been pleasing. Against the ARC PCI (Asset Risk Consultants Private Client Indices) we have achieved stronger returns over the three months and longer term. Against the IA sector peer groups over the three and six months we have marginally outperformed but with less volatility and a lower equity content than the peer group average.

Market summary over the last quarter

- The US dollar continued to weaken despite a second interest rate rise at the end of June.
- Emerging markets performed strongly over the three months despite government actions in China and India.
- Central banks are talking of tightening monetary policies.
- The oil price rose over the quarter due to disruption in the Gulf of Mexico and Saudi Arabia's declaration of war on Qatar.

Our shorter-term outlook

- A weakening US dollar will likely support emerging market equities.
- Tightening credit markets will slow growth in leveraged economies.
- Current levels of volatility are unusually low and we do not expect this to continue.
- The UK equity market remains very sensitive to both Brexit and sterling.